

rules. Answering this question in the affirmative, the Commission tentatively concludes that the add back is necessary to achieve the desired mix of carrier flexibility and regulatory control which was intended under the non-pure price cap plan which was adopted.

The price cap plan gives the LECs substantial flexibility in their rates and earnings, to encourage greater efficiency. However, for the LECs the Commission established limits on this flexibility and a range of reasonableness for LEC earnings. Without add-back, the double-counting of backstop adjustments could effectively permit earnings outside the range of returns judged to be reasonable.^{37/}

Thus, contrary to the arguments advanced by Pacific Bell and others, implementation of a backstop mechanism to guard against effective earnings outside the range set by the Commission is not inimical to the productivity incentives established for price cap LECs, but is an indispensable part of the price cap structure as envisioned and implemented by the Commission from the outset.

C. The Commission May Logically Distinguish Between Requiring Add Back For Sharing Adjustments While Prohibiting Add Back For Low-End Adjustments

Rate of return calculations historically have included add back of revenue reductions resulting from refunds based either on overearnings or disallowances.^{38/} They have not included add back of revenue increases resulting from rate increases implemented because of prior period underearnings. To properly understand the reason the Commission has drawn this distinction between its treatment of sharing adjustments and LFA adjustments,

^{37/} NPRM, para. 13.

^{38/} See, line 6 of FCC Form 492.

it is important to recognize what each adjustment is designed to accomplish.

- "Sharing" was designed to "share" past excess earning with ratepayers. i.e., to provide the equivalent to a refund.
- The "Low End Adjustment" was designed to allow carriers that are underearning to raise rates to a level that allows them to earn reasonably in the future (to continue to attract capital, etc.); i.e., to allow for a retargeting of prices, not to provide a refund.

In short, the LFA is designed to retarget future rate of return, not to compensate carriers for past poor performance.^{39/}

Several LECs contend that requiring add back for prior year sharing adjustments conflicts with the Commission's intent to have the sharing mechanism operate as a one time adjustment to a single year's rates.^{40/} However, an add back requirement for prior sharing amounts does not constitute a "second adjustment" to the carriers' pricing plans. Rather, it operates as a rate of return reporting requirement for the period in which the "one time" adjustment has been made. The language excerpted by the

^{39/} Thus, NYNEX incorrectly characterizes LFA as "like backbilling, because the LEC receives the LFA revenues in the reporting period to compensate it for underearnings in the prior period." NYNEX Direct Case, Exhibit 2, p. 7. A similarly flawed understanding attends the statement found in the example cited in NYNEX Exhibit 2, Attachment A, which states: "In year 2, the LEC is entitled to an exogenous adjustment of +2.25 percent in order to prospectively recoup the shortfall from the base year." (emphasis added). The purpose of the exogenous adjustment of +2.25 percent is to prospectively retarget to the level of the lower adjustment mark.

^{40/} See, US West Direct Case, pp. 8-9, and Bell Atlantic Direct Case, p. 6.

LECs from the LEC Price Caps Order which refers to a "one time adjustment" contemplates a one time pricing change to effectuate the return of prior period earnings to be shared with ratepayers. Without an add back requirement the sharing mechanism will have an unintended continuing impact on future year earnings by incorporating a refund of earnings made in the prior period into the revenue stream of the period under review.

Requiring price cap LECs to add back prior year sharing amounts, while not allowing add back for low-end adjustments, as urged by the Committee, is supported not only by the Commission's rules and past practices but is a logical extension of the more competitive marketplace sought to be achieved under price cap regulation. In a fully competitive, unregulated environment, customers receive the benefits of productivity enhancements immediately in the form of lowered prices (i.e., there are no "excess earnings"). Intervention of regulatory processes, on the other hand, slow the delivery of productivity benefits (i.e., lower prices) to ratepayers. If prior year sharing revenues are not "added back", then there is no "sharing" of revenues from the prior period; there is simply a going-forward retargeting of prices to a lower rate of return. Thus, without prior year sharing add back, rather than simply delaying receipt of the benefits of productivity enhancements, ratepayers are denied such benefits altogether.

Similarly, in a competitive environment there is no "low-end adjustment" protection for service providers that fail to meet

the productivity levels of their competition. Without reiterating in detail its previously expressed views relative to the merits (or lack thereof) of the low end adjustment mechanism^{41/}, the Committee strongly opposes allowing the low end adjustment mechanism to be manipulated and changed from a forward-looking protective measure to a "backbilling" mechanism. Although it is possible that unusually low earnings may be attributable to circumstances beyond the control of individual carriers, it is equally likely that such earnings situations may be directly attributable to poor or inappropriate management of a carrier's regulated operations. Incorporating add back of LFA revenue amounts into the rate of return reporting requirements would in essence reward poor performance and eliminate the very incentives to improve productivity that price caps is intended to foster.

III. Issue 7: To What Category Or Categories Should The LIDB Per Query Charges Be Assigned

While the LEC Direct Cases demonstrate that no rule prohibits them from assigning LIDB query charges to the categories they have chosen (almost universally, the local

^{41/} As stated in pleadings directed at prior years' annual access tariff filings, the Committee is troubled by the Commission's decision not to require a specific showing of need or efficiency in conjunction with a lower formula mark adjustment. See, Ad Hoc Committee Petition filed in response to the 1992 Annual Access Charge Tariffs.

transport category),^{42/} the Committee believes that the LIDB per query charge more appropriately belongs in the local switching category. There is little question but that the nature and function of the LIDB per query charge is closer to the nature and function of traditional local switching elements than traditional local transport elements. However, the majority of LECs have assigned the LIDB per query charge (a charge that does not recover any transport related costs) to the local transport category.

The Committee believes that similar new service category assignment questions will occur with increasing frequency in the future, and that their strategic importance should not be overlooked by the Commission. To remove uncertainty and provide for uniform and rational assignment methodologies, the Commission should initiate a rulemaking to develop specific requirements and functional guidelines that will aid in the assignment of new services to the appropriate price caps categories in the future. Such guidelines will curtail the ability of LECs to manipulate these assignments to their advantage based upon the current lack of specificity in the rules.

V. Conclusion

In consideration of the matters discussed herein and in the its Petition For Partial Rejection And Investigation filed April 27, 1993, the Ad Hoc Committee urges the Commission to reject as

^{42/} The price caps rules do not incorporate definitions to aid in the appropriate assignment of new services.

unlawful the tariffs of those LECs that contain exogenous cost adjustments related to SFAS-106 implementation and those LECs that have not properly accounted for prior period sharing and low end adjustments implemented in their 1992 Annual Access Tariff Filings in the rate of return calculations used in their 1993 Annual Access Tariff Filings.

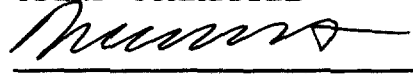
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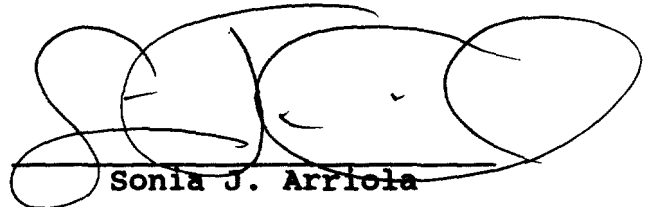
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